

Extract from Economic and Structural Report

Swedbank's analysis of the international and Swedish economies

14 August 2008

A stressed global economy is slowing Swedish growth

- Due to the protracted financial crisis, high commodity prices and downbeat sentiment, growth prospects for the global and Swedish economies have worsened during the last half year. We have revised our global GDP growth forecast downward by $\frac{1}{4}$ percentage point to 3.7% this year and by slightly over $\frac{1}{2}$ percentage point to 3.4% next year. Not until the end of the forecast period will a global recovery begin.
- Sweden is impacted by both weaker global economic conditions and negative wealth effects as households become more cautious. We see good reason for consumers' increased pessimism. GDP will grow by 1.8% this year and 1.7% in 2009, a sharp downward revision since January.
- If Swedish inflation begins to retreat in late autumn, the Riksbank can ease monetary policy next year. Economic conditions and strong government finances will also allow for expansionary fiscal policies.
- Considering the stress that the global economy is undergoing, with two major chocks (financial and commodity crises), Sweden, with GDP growth of 1.5 - 2%, is managing reasonably well. The reasons for this include its economic policies and relatively good export and investment trends.
- Protracted global financial and economic concerns, a sharp decline in the real estate and labor markets, rising commodity prices and higher cost pressures are important risks on the downside.

Cecilia Hermansson

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When the dominos start falling ...

Growth prospects for the global and Swedish economies have clearly worsened in the last half year. Financial worries still remain, commodity prices have risen substantially and the prevailing sentiment among businesses and households has become gloomier.

Poorer growth prospects mean ...

We have revised our forecast for global GDP growth downward to 3.7% and 3.4% in 2008-2009. Not until the end of 2009 and 2010 do we now anticipate a global recovery. Sweden is also growing considerably slower according to our new forecast. This year real growth is estimated at 1.8% and next year 1.7% – over one percentage point lower than in the January forecast.

... relatively large downward revisions compared with our January forecast

The global economy is under pressure from two chocks. One contains deflation risks and is related to the build-up in debt, falling housing prices and the financial crisis. The other has arisen due to rising commodity prices, with higher inflation and stagflation risks as a result. These chocks are two sides of the same coin, caused by global savings imbalances, a poor choice in currency regimes by emerging countries and expansionary monetary policies.

The two chocks facing the world are two sides of the same coin

In the short term there is a risk of global recession. At the same time inflation is disconcertingly high, particularly in many emerging economies where demand is solid. In the slightly longer term there is more of a threat to the global economy from excessive resource utilization, since the supply of raw materials can't keep pace with demand.

The threats to the global economy differ in the short and long term

Economic policies have to be more globally responsible. Every country can't grow its way out of the current crisis. A consolidation stage is needed where imbalances are the highest (read the U.S.). Central banks must include asset prices and credit growth in their inflation analyses. Emerging economies (read China) must introduce more appropriate currency regimes.

The recession after the turn of the new millennium carried over into the corporate sector after a period of excessive IT investments. Now the household sector has to adjust its balance sheets, reduce debt and save more. This will slow GDP growth. A household-led economic slowdown is likely to be more protracted, though probably not as extensive as a business-led recession. Global trade is affected slightly less than in the last downturn. Labor markets are slowing, though probably not as much. The risks are weighing on the downside. The credit crunch could complicate the situation.

There are differences between this slowdown and previous recessions

Compared to the recessions of the early 1980s and '90s, the fast-growing emerging economies mean more to global growth. These economies are also slowing due to lower demand in Europe, Japan and the U.S., but not to the same extent. The recession began in the U.S. in 2006-2007. Not until the last quarter has a major downturn become apparent in the EU. Growth is also slowing significantly in Japan. We expect activity

to further decline during the forecast period before prospects improve.

The effects of the financial crisis and negative wealth effects will probably be felt most in the U.S. and Europe. The financial crunch resembles a three-act tragedy. In Greek tragedies, hubris and arrogance is a common ingredient, as they were at the start of this financial crisis. We are now in the second act, which has lasted longer than hoped.

The financial crisis resembles a Greek drama in three acts

One reason why the crisis worsened beyond the initial USD 50-100 billion in subprime loans was the falling dominos that created a full-scale crisis of confidence. Difficulties evaluating and understanding innovative credit instruments have hurt confidence and in turn led to new, even greater losses. The third act in this drama will begin with a turnaround in the U.S. housing market. If we were to see a recovery similar to the one after the housing bubble in 1978-82, it would take four years of slow growth until the summer of 2009 before we hit bottom. Only then – and with the help of regulatory changes and better information on loan losses – will confidence return.

Falling dominos have led to a much greater financial crisis than first expected

The Swedish economy is being slowed by weaker global growth and negative wealth effects domestically. The sentiment among Swedish households has become much gloomier. This is to be expected since there are so many negative factors in play at the same time, including a weaker economy and job market as well as slower income and wealth growth. High debts and rising interest rates have driven up the interest ratio to a very high level. Even if households remain an important engine, they are now driving in a lower gear.

Global economic conditions and wealth effects domestically are slowing Swedish GDP

In much of the corporate sector, we expect relatively positive development. The growth rate for Swedish exports will decline, but is still decent. Corporate investments are slowing, and in the housing sector they are falling after several years of rapid growth. Because of weak productivity growth, companies continue to seek out efficiencies to reduce their costs.

What can economic policy contribute in a situation with weak growth and high inflation? We anticipate a period of falling inflation beginning in late autumn. Next year the Riksbank can cut the repo rate at the same time that fiscal policies become more expansionary through income tax cuts, higher state subsidies to the municipal sector and more public investment. Support from economic policies will soften the recession slightly, though there is no quick fix. Just as important will be to implement structural reforms to strengthen Sweden's growth prospects once the economy rebounds.

Economic policies can soften the impact of the recession slightly, but there is no quick fix

The level of uncertainty in the above forecast is very high and we see significant economic risks on the downside. Still, if our expectations are met, Sweden's situation would have to be considered fairly good given the pressures facing the global economy.

Cecilia Hermansson

Swedbank's economic forecast for Sweden August 2008

National Accounts

<i>Change in volume (%)</i>				
	2006	2007 ¹⁾	2008e ¹⁾	2009e ¹⁾
Consumer spending	2.5	3.0 (3.1)	2.1 (2.5)	1.7 (2.9)
Public spending	1.5	1.1 (0.7)	0.8 (0.8)	1.2 (1.2)
Fixed gross expenditures	7.7	8.0 (8.5)	4.0 (4.5)	3.1 (4.0)
- Businesses excl. housing	6.6	8.4 (9.2)	4.2 (4.5)	3.4 (3.8)
- Public agencies	7.1	3.3 (5.3)	5.8 (5.8)	8.0 (6.0)
- Housing	13.8	8.7 (8.8)	1.5 (3.5)	-3.0 (3.0)
Inventory investments ²⁾	0.2	0.7 (0.5)	-0.2(-0.3)	0.0 (0.0)
Exports, goods and services	8.9	6.0 (5.5)	5.0 (4.9)	4.0 (5.8)
Imports, goods and services	8.2	9.6 (9.2)	5.7 (5.2)	4.7 (6.0)
GDP	4.1	2.7 (2.8)	1.8 (2.2)	1.7 (2.8)
GDP, calendar-adjusted	4.4	2.9 (2.9)	1.5 (2.0)	1.9 (2.8)
Domestic usage	3.0	3.2 (3.2)	1.9 (2.2)	1.7 (2.4)
Net exports	1.0	-1.1(-2.2)	0.1 (0.3)	0.0 (0.4)

1) The figures from our latest forecast in January 2008 are in parentheses
2) Percentage change in previous year's GDP

Key Indicators

<i>Annual percentage change unless indicated otherwise</i>				
	2006	2007e	2008e	2009e
Nominal hourly wages, total	3.2	3.6	4.2	4.1
Nominal hourly wages, industry	3.2	3.9	3.4	3.6
Industrial production	5.1	2.7	1.7	2.0
CPI, annual average	1.4	2.2	3.8	2.8
CPI, Dec-Dec	1.6	3.4	3.7	1.9
CPIX, annual average	1.2	1.2	2.8	2.4
CPIX, Dec-Dec	1.2	2.0	3.0	2.4
Real disposable income	2.8	4.3	2.5	1.6
Savings ratio	7.1	8.3	8.6	8.5
Open unemployment ³⁾	7.0	6.2	6.3	7.0
Total unemployment ^{3) 4)}	10.0	8.1	8.2	9.0
Total labor force	1.9	2.4	1.1	-0.5
Current account balance ⁵⁾	8.5	8.4	8.0	7.8
Financial savings in public sector ⁵⁾	2.2	3.5	1.9	1.1
National debt (Maastricht) ⁵⁾	45.9	40.6	34.3	31.2

3) Percent of labor force, EU-harmonized
4) Open unemployment and labor market measures (individuals aged 16-64)
5) Percentage of GDP

A darkening cloud over the economy

In our January forecast, we predicted that global growth would fall short of its potential in 2008, but that the outlook would improve in 2009. In the last half year, however, global economic conditions have worsened more than expected.

- The assumption of a normalization in the financial markets in spring 2008 proved inaccurate. The financial crisis will be more protracted than expected in January.
- Commodity prices have significantly exceeded our assumptions, which also contributed to higher global inflation.
- Confidence among businesses and households has declined. A darkening sentiment is keeping demand in check in many countries.
- In January the European economy was expected to slow, but the combination of tighter monetary conditions, higher inflation and persistent financial worries are contributing to an even sharper decline.
- Economic conditions have worsened in emerging economies as well, but are still better than in mature economies.

We are therefore making relatively large downward revisions to global growth. In 2009 GDP growth is now projected at slightly over ½ percentage point lower than in the January forecast.

Global GDP forecast (%)

		August forecast			January forecast	
GDP growth (%)		2007	2008	2009	2008	2009
USA		2.0	1.5	1.5	1.50	2.25
EMU countries		2.6	1.6	1.4	1.75	2.00
of which:						
	Germany	2.6	1.8	1.4	1.75	2.00
	France	2.1	1.7	1.5	1.75	2.00
	Italy	1.4	0.6	0.9	1.25	1.50
	Spain	3.8	1.5	1.0	2.50	2.75
UK		3.1	1.7	1.5	1.75	2.25
Japan		2.1	1.2	1.3	1.50	1.75
China		11.9	10.0	9.0	10.5	9.75
India		9.3	7.2	7.5	8.0	8.50
Brazil		5.4	4.7	4.0		
Russia		8.1	7.5	6.8		
Global *		4.7	3.7	3.4	3.9	4.0
					(3.5)**	(3.8)**

Source: National statistics and Swedbank's forecasts.

* Countries representing about 70% of the global economy. The World Bank's weights from 2007 (purchasing power parity, PPP) have been used.

** The PPP weights used in the January forecast were from 2005. Moreover, Russia and Brazil were not included.

Swedish economy losing steam

Swedish economic growth is being hampered by weaker global conditions, at the same time that domestic demand is being held in check by lower consumer and corporate confidence. Economic policies will be more expansionary next year, softening the slowdown slightly. GDP will grow by 1.8% this year and 1.7% next year, compared to 2.2% and 2.8% in the January forecast.

Swedish exports

Swedish export conditions in 2008/09 have been revised downward due to weaker global growth prospects. Projected market growth of around 5.5% this year and 4.5% next year would mean less of a downturn than during the recession of 2001/02, however. Growth in emerging economies and strong demand for inputs and investment goods are helping to check the slowdown in global market growth. Due to rising unit labor costs in Swedish industry and lower demand from the important European market, which accounts for slightly over 70% of Swedish exports, exports of goods and services are expected to grow at a slower pace than projected market growth. We are forecasting that total export volumes will rise by slightly over 5% this year and 4% in 2009.

Investments

Investment growth in the Swedish economy is expected to drop in half in 2008 compared to 2007, from 8% last year to 4%. In addition to a weaker global economy and lower corporate investment needs, financing costs for investments have become higher in the aftermath of the global financial crisis. Next year we expect overall investments to further decrease due to lower housing investments. Higher interest expenses and a weaker increase in disposable income are affecting housing demand. Public sector investments in infrastructure, environmental improvements and energy supplies will positively contribute to projected investment growth of slightly over 3% in 2009.

Labor market

The outlook for the labor market has deteriorated in 2008. Weaker economic conditions and higher production costs are increasing the pressure on businesses to improve efficiencies. We expect the number of jobs to decline in 2009 by an average of 0.5% – or 20,000 workers – after four consecutive years of employment gains.

We expect resource utilization in the labor market to drop during the forecast period. A slowdown in job growth at the same time that the labor force continues to expand – though at a lower rate – will contribute to an increase in open unemployment to slightly over 7% of the working population by the end of 2009, from slightly over 6% in 2008. A weaker job market and lower profit margins for businesses are reducing the likelihood of much wage drift.

Swedish households

Swedish households are growing more pessimistic about their financial situation, the Swedish economy and the job market. We see good reason

for their diminished expectations. Income growth will slow next year, and household balance sheets have worsened significantly. We anticipate a stabilization or slight decline in the increase in the price of single-family homes during the forecast period owing to the weaker economy and labor market as well as lower housing affordability. The interest ratio – interest expenses as a percentage of disposable income – has also risen substantially and has now returned to the levels we saw in 1993/94. Consumer spending is growing more slowly, by 2.1% this year and 1.7% next year, while households are saving more.

Fiscal policy

Economic conditions, relatively strong public finances and public opinion are likely to force the government to adopt more expansionary fiscal policies next year. Unfinanced tax hikes and increased expenditures totaling SEK 30 billion are expected in the autumn budget. Without tax cuts for households, disposable income growth will be cut by half next year. This will lessen the decline in consumption growth, since households – given the government's current financial situation – expect the tax cuts to remain permanent.

Inflation and monetary policy

According to our forecast, inflation will begin to fall in October and reach the inflation target in autumn 2009. The Riksbank is likely to raise the repo rate one more time in September, although the situation has been more uncertain now that oil prices have dropped and the economy has weakened more than expected. At the same time inflation has risen more than the Riksbank previously anticipated, and inflation expectations remain high. Next year, when the trend toward lower inflation becomes more evident, the Riksbank is likely to cut the repo rate, which, based on our projections, will be 4% by the end of the forecast period. The krona will rise slightly in value against the euro, but weaken more clearly against the dollar. TCW is projected at 123 at the end of the forecast period. The report includes an analysis of the tightness of monetary policy. Applying a simple Taylor rule, we see that the repo rate has been behind the curve since 2005. The increase in the interest ratio shows that household sensitivity to a hike in interest rates is considerably greater under these circumstances than during the similar rise in 2005.

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